

THE BULGARIAN ECONOMY - July 2009

A Summary of the Report by the CENTER FOR ECONOMIC DEVELOPMENT¹

MACROECONOMIC DYNAMICS.

The drop in the Bulgarian economy will continue during the second and third quarter and will eventually weaken or turn into weak growth in the beginning of 2010.

With two consecutive drops in the *gross domestic product* in comparison with the previous quarter – domestically by 1.6% for the final quarter of 2008 and by 5% for the first quarter of this year – it is considered that the economy has entered a recession. On an annual basis our economy contracted by 3.5% during the first quarter. Most disconcerting on the *production* side of the *GDP* is the decline in the industrial sector, especially the deepening fall in value-added industry (by 14.5% on an annual basis). A drop is also now apparent in construction (by 6.1%). The agricultural sector also contracted (by 4.8%). Only the services sector continues to grow, although three times slower when compared to the growth one year ago. The drop in our economy on the *end consumption* side of the *GDP* is determined by the fall in domestic demand. Investments decreased most significantly (by 14%), while household consumption fell by 6%. The fall in foreign commerce in products and services deepened, but its net effect contributed to the softening of the total drop in the economy being that the contraction of imports is greater than the contraction of exports.

The monthly data on industry, construction and commerce including the period up to May indicate a deepening of the fall. We expect that the drop in value-added industry during the second quarter will be significantly greater in comparison with that from the first quarter. The drop in construction will continue in the upcoming quarters. Household consumption will be curbed and cautious in the next quarters. On the other hand, the low and attractive prices could energize commerce at least in the area of consumer products. **We expect the influence of domestic trade on the value-added dynamics in the services sector to be more likely positive in the upcoming quarters.**

The trend **toward the decrease in the current account deficit of our balance of payments since December** continues due in the greatest extent to the nominal drop in the deficit in the trade balance (FOB/CIF) by 37% on an annual basis, as well as to the significant decrease in the negative balance in services. Keeping in mind the expectations of maintaining the tendencies in the foreign sphere since the beginning of the year, and especially foreign trade, the following months will continue to see an improvement in the current account deficit. A positive aspect in the development of *foreign trade* is the increasing pace of the decrease in imports in comparison with exports. Significant structural changes have been observed in the types of products as well as the geographic destination of the trade. For the period from January to May *DFI* were two times less for the same period one year earlier in terms of volume. It would be thought to be a success if the year ended with a flow of 4-4.5 billion euros in foreign capital.

From the beginning of the year **up to June inflation barely reached 0.6%** and is many times lower than what it was the previous years. That reflects the delayed dynamics of the international prices, in respect to the costs to the manufacturer on the domestic market, as well as the lack of pressure from the side of domestic consumption. Keeping in mind the expectations for an overall economic drop domestically at least until the end of the year, even if there is a certain tepid growth

¹ The Center for Economic Development is an independent research organization located in Sofia (www.ced.bg). The full text of the report can be found in Bulgarian at the following address: www.manager.bg ...

in consumption, we continue to expect more months of deflation in consumer prices. For the full year 2009 we do not expect inflation to rise to more than 2-3% annually.

The contraction of our economy during the first quarter of 2009 was inevitably accompanied by a **decline in employment levels, however small it may be for now**. In the upcoming quarters we expect the restructuring of employment to continue. Unemployment exceeded its levels, compared to one year earlier, during the second quarter and will continue to do so in the following quarters, mostly as a result of the contraction in industrial and construction productivity.

POLICIES REGARDING BUSINESS ESTABLISHMENTS. In order to **encourage entrepreneurship** the capital in the Bulgarian Development Bank was increased by an additional 2.3 million levs in June. By mid June 2009 69% of the funds from the credit lines from the DBD had been apportioned. The largest portion was granted to the processing industry – 26%. In May 2009 the Ordinance for the Implementation of Preliminary Control over **Public Procurement** Procedures, for projects which are financed completely or in part by funds from European Funds, was published. In the area of **the anti-corruption battle**, changes were made during March to *The Commission for Prevention and Countering of Corruption*, which accepted an action plan for 2009 in April; its functions were also updated. Most of the 30 measures and acts had June 30 as their date of fulfillment, while others were of a more general character and will hardly contribute to more effective anti-corruption activities.

PUBLIC FINANCES. The budget balance slid downwards toward a deficit, although in May a small budget surplus was still recorded. Compared to April it fell by 17.8%, while in comparison with May last year the drop was by 83.2%. It is expected that a deficit will become fact during July. On an annual basis revenues decreased by 6.1%, while expenditures grew by 24.8%. The large growth in social expenditures is at the foundation of the decrease in the budget balance for May. The fiscal reserve by May 2009 again began to fall after a slight growth in April. The optimistic expectations for this year are to maintain the levels from the end of 2008. The revenues from indirect taxation decreased in comparison with May 2008: from VAT – a drop of 20.5%, from excises – a drop of 1.07%, from customs' duties – a drop of 28.2%. The proceeds from VAT continue to fall on an annual basis, mainly due to the drastic contraction in the volume of imports into the country. Since February there is an ever increasing drop in revenues collected on an annual basis, which indicates that the shortfall under the conditions of a worldwide financial crisis will be even greater than in 2008. As compared to the same period from the previous year, the revenues from direct taxation also saw a drop – by 8.3%. The decrease in corporate income taxes was by approximately 20% because more and more companies are running at a loss. The capital expenditures in the state budget marked a growth of 95.1% compared to May of last year. On the other hand, in order to improve the budget balance under crisis conditions one could expect there to be a decrease specifically in these expenditures.

SOCIAL AND HEALTHCARE POLICIES. Due to the worsening of the overall business conjuncture, the interest of employers toward the preferential conditions offered by the Employment Agency to encourage employment and qualifications has decreased. Local intervention in the labor market has been activated via the mechanisms of the European Structural Funds. The stagnation of the labor market has reflected on the revenues for Social Security, where a realistic risk of a deficit exists. The budget of the National Health Insurance Fund also expects to experience a shortfall due to low collection. The private retirement funds have steadied their financial indicators and their profitability on an annual basis has already turned positive. The investment strategy of the Silver Fund, however, remains passive.

FINANCIAL SYSTEM. Monetary supply continued to slow its pace of growth to barely 4.6% on an annual basis at the beginning of May 2009. *Interest rates* on mortgages and consumer credits

grew in May 2009 as compared with April. The interest on consumer loans reached their highest levels since the beginning of 2004. In the space of just one month the interest rate on newly granted consumer loans were raised by approximately 30%. Including fees and commissions the rate on consumer credit rose to 15.01%, while home owners' loans rose to 11.01%. The high interest rates are proof that the banks' resources continue to be expensive, but also that they are limiting loan grants to the maximum under crisis conditions. *The credits provided* to companies and households are 16% more than in May 2008. Mortgages to physical individuals remain the most dynamic component as compared to consumer credits. It is disconcerting that, after the drop in March 2009, the share of bad loans is beginning to grow quickly once again. At the end of May the sum total of assets in *the banking system* recorded a wear monthly decrease of 0.4%, but on an annual basis they are increasing. The coefficient of liquid assets at the end of May was 20.6% and guarantees a good coverage of funds attracted into the system. *The National Guarantee Fund will accept up to 50% of the credit risk* on loans to small- and medium-sized businesses. Agreements have been signed with five commercial banks to grant portfolio guarantees in the amount of 50 million levs.

Capital Market. The dominant, negative trend on worldwide capital markets over the last two years turned around for the first time during the second quarter of 2009, as almost all of them registered meaningful growth. This positive attitude was nurtured by several facts and circumstances, which originated mostly from the American economy, were interpreted as positive signs that the peak of the financial and economic crisis was passing. Some held the exact opposite view-point, namely that these facts testify to the deepening of the crisis and not to its passing; they base this idea on the disbalance which appeared in the interest levels, which makes economic growth more difficult and causes inflation in the longer-term. It is still impossible to claim that clear signals exist either for the improvement or the worsening of the condition of the economy and markets.

Most markets, including Bulgaria's regardless of the growth realized in the second quarter, still remain hesitant and relatively volatile. Despite the growth of nearly 25% realized on the main SOFIX index (up to 357 points), it is necessary to note that it came amid ever decreasing liquidity. The market movements during the quarter depended to an ever greater extent on the individual attitude of a small number of investors and not on fundamental factors. Despite this, all the indices succeeded in regaining their losses from the first quarter, while the SOFIX reached its level from the end of 2008. The wider index marked a minimal drop of 3.7%, yet still remaining above the original level from January 2005. The market capitalization of the companies traded grew by more than 10% over the period. Commercial turnover, however, continues to drop – experiencing an overall drop of 36% in relation to the previous quarter, while compared to one year earlier the reduction is quite more noticeable (66%).

ENERGETICS. With the new prices for electricity in effect from July 1, 2009, CEZ offers the least expensive daytime rate, while E.ON offers the least expensive nighttime rate. An interim agreement was signed for "Southern Flow". There is a possibility that Bulgaria will have a second gas depot if she can overcome the existing legal obstacles.

TRANSPORT. During July an agreement was signed with Italy regarding the construction of **transport corridor № 8**. The **BRW** received a license to provide public transportation services via fast and passenger trains for the next 15 years. The economic crisis has reflected most negatively among the freight rail transport being that the passenger transport has a certain guarantee due to the contract made with the state. The crisis also hit **automotive transportation** – the Ministry of Transport informed the EC in April of the desire of Bulgaria that the mechanisms foreseen in art. 4 of regulation № 3916/90, regarding the commencement of procedures to declare *a crisis in the automotive freight transport market*, be applied being that the circumstances

described in art. 2 of the regulation exist. No point of view has yet been received from the EC. In the middle of June the Directorate-General for Regional Development of the EC approved the signing of **roads contracts** (as part of the Transport, Regional Development and Transit Roads operational programs), for which a sum of 1.25 billion euros is foreseen.

CONSTRUCTION AND REAL ESTATE. Entrepreneurs have re-oriented themselves from private investments to those, which are financed by the state and operational programs. During the second quarter *homes* depreciated on average by 12.4%. Residential real estate is 16% lower than the peak during the third quarter of 2008 and 8.4% lower than at the beginning of the year. A decrease between 10 and 20 percent has been observed in the base prices for new construction, depending on the specific site. We expect sales to remain low at least until the end of the year. The only foreign buyers left on the *vacation home* market are Russians. The situation in the winter resorts is much more severe. Properties in the low price segment are being offered for no more than 50-60% of their worth from around three years ago, and construction has basically stopped.

HIGH TECH AND TELECOMMUNICATIONS. According to research by IDC, the computer technology market domestically is at its weakest levels over the last 3 years. Pirated software continues to predominate (68% for 2008) in Bulgaria. The portability of registered features is now a fact.

TOURISM. During the first quarter of 2009 the beds for overnight accommodations in the country were 15.3% more than one year earlier. At the same time, the number of actual overnight stays in those beds decreased by 11.2%. **The number of actual overnight stays** by foreign citizens decreased by 19.0%. Actual overnight stays by Bulgarian citizens decreased by 5.6%. According to the experts at the State Tourism Agency the tourism branch expects to make up for the ebb in foreign tourists by the end of 2009 and to reach the same number of guests as in 2008. During the current year, however, the revenues in the sector will possibly fall by 9% in comparison to 2008.

AGRICULTURE. Despite the expectations that the significance of agriculture would grow under crisis conditions, during the first quarter of 2009 the sector realized production close to 5% lower than the same period in 2008. The drying out during the spring will be reflected in the crop yields, but, in general, the harvest will be good. Hope continues that eurofinancing will encourage investments in the sector.